

transferor is a foreign insurance company that is a dual resident corporation under § 1.1503(d)-1(b)(2)(ii).

(e) *Special rule denying the use of a dual consolidated loss to offset tainted income*—(1) *In general.* Dual consolidated losses incurred by a dual resident corporation that are subject to the domestic use limitation rule under paragraph (b) of this section shall not be used to offset income it earns after it ceases to be a dual resident corporation to the extent that such income is tainted income.

(2) *Tainted income*—(i) *Definition.* For purposes of paragraph (e)(1) of this section, the term *tainted income* means—

(A) Income or gain recognized on the sale or other disposition of tainted assets; and

(B) Income derived as a result of holding tainted assets.

(ii) *Income presumed to be derived from holding tainted assets.* In the absence of evidence establishing the actual amount of income that is attributable to holding tainted assets, the portion of a corporation's income in a particular taxable year that is treated as tainted income derived as a result of holding tainted assets shall be an amount equal to the corporation's taxable income for the year (other than income described in paragraph (e)(2)(i)(A) of this section) multiplied by a fraction, the numerator of which is the fair market value of all tainted assets acquired by the corporation (determined at the time such assets were so acquired) and the denominator of which is the fair market value of the total assets owned by the corporation at the end of such taxable year. To establish the actual amount of income that is attributable to holding tainted assets, documentation must be attached to, and filed by the due date (including extensions) of, the domestic corporation's tax return or the consolidated tax return of an affiliated group of which it is a member, as the case may be, for the taxable year in which the income is generated. See § 1.1503(d)-7(c) *Example 22*.

(3) *Tainted assets defined.* For purposes of paragraph (e)(2) of this section, tainted assets are any assets acquired by a domestic corporation in a non-recognition transaction, as defined in

section 7701(a)(45), any assets otherwise transferred to the corporation as a contribution to capital, or any assets otherwise received from a separate unit or a transparent entity owned by such domestic corporation, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a dual resident corporation or at any time thereafter.

(4) *Exceptions.* Income derived from assets acquired by a domestic corporation shall not be subject to the limitation described in paragraph (e)(1) of this section, and in addition shall not be treated as tainted assets as defined in paragraph (e)(3) of this section, if—

(i) For the taxable year in which the assets were acquired, the corporation did not have a dual consolidated loss (or a carryforward of a dual consolidated loss to such year); or

(ii) The assets were acquired as replacement property in the ordinary course of business.

(f) *Computation of foreign tax credit limitation.* If a dual consolidated loss is subject to the domestic use limitation rule under paragraph (b) of this section, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner shall compute its foreign tax credit limitation by applying the limitations of paragraph (c) of this section. Thus, the items constituting the dual consolidated loss are not taken into account until the year in which such items are absorbed.

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#### § 1.1503(d)-5. Attribution of items and basis adjustments.

(a) *In general.* This section provides rules for determining the amount of income or dual consolidated loss of a dual resident corporation. This section also provides rules for determining the income or dual consolidated loss attributable to a separate unit, as well as the income or loss attributable to an interest in a transparent entity. Paragraph (b) of this section provides rules with respect to dual resident corporations. Paragraph (c) of this section provides rules with respect to separate units and interests in transparent entities. These determinations are required for various purposes under section 1503(d). For example, it is necessary for

purposes of applying the domestic use limitation rule under § 1.1503(d)-4(b) to a dual consolidated loss, and for determining the extent to which a dual consolidated loss is available to offset income as provided under § 1.1503(d)-4(c). These determinations are also necessary for purposes of determining whether the amount subject to recapture may be reduced pursuant to § 1.1503(d)-6(h)(2). Paragraph (d) of this section provides rules with respect to the foreign tax treatment of items. Paragraph (e) of this section provides rules regarding the treatment of items where a dual resident corporation, separate unit, or transparent entity only qualified as such during a portion of a taxable year. Paragraph (f) of this section provides rules for determining the assets and liabilities of a separate unit. Finally, paragraph (g) of this section provides rules for making basis adjustments to stock of certain members of a consolidated group and to certain interests in partnerships. The rules in this section apply for purposes of §§ 1.1503(d)-1 through 1.1503(d)-7.

(b) *Determination of amount of income or dual consolidated loss of a dual resident corporation*—(1) *In general.* For purposes of determining whether a dual resident corporation has income or a dual consolidated loss for the taxable year, and except as provided in paragraph (b)(2) of this section, the dual resident corporation shall compute its income or dual consolidated loss taking into account only those items of income, gain, deduction, and loss from such year (including any items recognized by such corporation as a result of an election under section 338). In the case of an affiliated dual resident corporation, such calculation shall be made in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income. See also paragraphs (d) and (e) of this section.

(2) *Exceptions.* For purposes of determining the income or dual consolidated loss of a dual resident corporation, the following shall not be taken into account—

- (i) Any net capital loss of the dual resident corporation;
- (ii) Any carryover or carryback losses; or

(iii) Any items of income, gain, deduction, and loss that are attributable to a separate unit or an interest in a transparent entity of the dual resident corporation.

(c) *Determination of amount of income or dual consolidated loss attributable to a separate unit, and income or loss attributable to an interest in a transparent entity*—(1) *In general*—(i) *Scope and purpose.* Paragraphs (c) through (e) of this section apply for purposes of determining the income or dual consolidated loss attributable to a separate unit, and the income or loss attributable to an interest in a transparent entity, for the taxable year. In the case of an affiliated domestic owner, this determination shall be made in accordance with the rules set forth in the regulations under section 1502 governing the computation of consolidated taxable income. These rules apply solely for purposes of section 1503(d).

(ii) *Only items of domestic owner taken into account.* The computation made under paragraphs (c) through (e) of this section shall be made using only those existing items of income, gain, deduction, and loss of the separate unit's or transparent entity's domestic owner (or owners, in the case of certain combined separate units), as determined for U.S. tax purposes. These items must be translated into U.S. dollars (if necessary) at the appropriate exchange rate provided under section 989(b), as modified by regulations. The computation shall be made as if the separate unit or interest in a transparent entity were a domestic corporation, using items that are attributable to the separate unit or interest in a transparent entity. However, for purposes of making this computation, net capital losses, and carryover or carryback losses, of the domestic owner shall not be taken into account. Items of income, gain, deduction, and loss that are otherwise disregarded for U.S. tax purposes shall not be regarded or taken into account for purposes of this section. See § 1.1503(d)-7(c) *Examples 6 and 23 through 25.*

(iii) *Separate application.* The attribution rules of this section shall apply separately to each separate unit or interest in a transparent entity. Thus, an item of income, gain, deduction, or loss

shall not be considered attributable to more than one separate unit or interest in a transparent entity. In addition, for purposes of this section items of income, gain, deduction, and loss attributable to a separate unit or an interest in a transparent entity shall not offset items of income, gain, deduction, and loss of another separate unit or interest in a transparent entity. See § 1.1503(d)-7(c) *Example 24*. See also the separate unit combination rule in § 1.1503(d)-1(b)(4)(ii).

(2) *Foreign branch separate unit*—(i) *In general*. Except to the extent provided in paragraph (c)(4) of this section, for purposes of determining the items of income, gain, deduction (other than interest), and loss of a domestic owner that are attributable to the domestic owner's foreign branch separate unit, the principles of section 864(c)(2), (c)(4), and (c)(5), as set forth in § 1.864-4(c), and §§ 1.864-5 through 1.864-7, shall apply. The principles apply without regard to limitations imposed on the effectively connected treatment of income, gain, or loss under the trade or business safe harbors in section 864(b) and the limitations for treating foreign source income as effectively connected under section 864(c)(4)(D). Except as provided in paragraph (c)(2)(iii) of this section, for purposes of determining the domestic owner's interest expense that is attributable to a foreign branch separate unit, the principles of § 1.882-5, as modified in paragraph (c)(2)(ii) of this section, shall apply. When applying the principles of section 864(c) (as modified by this paragraph) and § 1.882-5 (as modified in paragraph (c)(2)(ii) of this section), the foreign branch separate unit's domestic owner shall be treated as a foreign corporation, the foreign branch separate unit shall be treated as a trade or business within the United States, and the other assets of the domestic owner shall be treated as assets that are not U.S. assets.

(ii) *Principles of § 1.882-5*. For purposes of paragraph (c)(2)(i) of this section, the principles of § 1.882-5 shall be applied, subject to the following modifications—

(A) Except as otherwise provided in this section, only the assets, liabilities, and interest expense of the domestic

owner shall be taken into account in the § 1.882-5 formula;

(B) Except as provided under paragraph (c)(2)(ii)(C) of this section, a taxpayer may use the alternative tax book value method under § 1.861-9(i) for purposes of determining the value of its U.S. assets pursuant to § 1.882-5(b)(2) and its worldwide assets pursuant to § 1.882-5(c)(2);

(C) For purposes of determining the value of a U.S. asset pursuant to § 1.882-5(b)(2), and worldwide assets pursuant to § 1.882-5(c)(2), the taxpayer must use the same methodology under § 1.861-9T(g) (that is, tax book value, alternative tax book value, or fair market value) that the taxpayer uses for purposes of allocating and apportioning interest expense for the taxable year under section 864(e);

(D) Asset values shall be determined pursuant to § 1.861-9T(g)(2); and

(E) For purposes of determining the step-two U.S. connected liabilities, the amounts of worldwide assets and liabilities under § 1.882-5(c)(2)(iii) and (iv) must be determined in accordance with U.S. tax principles, rather than substantially in accordance with U.S. tax principles.

(iii) *Exception where foreign country attributes interest expense solely by reference to books and records*. The principles of § 1.882-5 shall not apply if the foreign country in which the foreign branch separate unit is located determines, for purposes of computing taxable income (or loss) of a permanent establishment or branch of a non-resident corporation under the laws of the foreign country, the interest expense of the foreign branch separate unit by taking into account only the items of interest expense reflected on the foreign branch separate unit's books and records. In such a case, only those items of the domestic owner's interest expense reflected on the foreign branch separate unit's books and records (as provided in paragraph (c)(3)(i) of this section), adjusted to conform to U.S. tax principles, shall be attributable to the foreign branch separate unit. This paragraph shall not apply where the foreign country does not use a method of attributing interest based solely on the interest that is reflected on the books and records. For

example, this paragraph does not apply if the foreign country uses a method for attributing interest expense similar to § 1.882–5 or that set forth in the Organization for Economic Co-operation and Development Report on the Attribution of Profits to Permanent Establishments, Part II (Banks), December 2006. See <http://www.oecd.org>.

(3) *Hybrid entity separate unit and an interest in a transparent entity*—(i) *General rule.* This paragraph (c)(3) applies to determine the items of income, gain, deduction, and loss of a domestic owner that are attributable to a hybrid entity separate unit, or an interest in a transparent entity, of such domestic owner. Except to the extent provided in paragraph (c)(4) of this section, the domestic owner's items of income, gain, deduction, and loss are attributable to the extent they are reflected on the books and records of the hybrid entity or transparent entity, as applicable, as adjusted to conform to U.S. tax principles. See § 1.1503(d)–7(c) *Examples 23 through 26*. For purposes of this paragraph (c)(3), the term “books and records” has the meaning provided under § 1.989(a)–1(d). The treatment of items for foreign tax purposes, including under any type of foreign anti-deferral regime, is not relevant for purposes of determining whether items are reflected on the books and records of the entity, or for purposes of making adjustments to such items to conform to U.S. tax principles. The method described in the second sentence of this paragraph shall not apply to the extent that the Commissioner determines that booking practices are employed with a principal purpose of avoiding the principles of section 1503(d), including inconsistently treating the same or similar items of income, gain, deduction, and loss. In such a case, the Commissioner may reallocate the items of income, gain, deduction, and loss between or among a domestic owner, its hybrid entities, its transparent entities (and interests therein), its separate units, or any other entity, as applicable, in a manner consistent with the principles of section 1503(d) and which properly reflects income (or loss).

(ii) *Interests in certain disregarded entities, partnerships, and grantor trusts owned by a hybrid entity or transparent*

*entity.* This paragraph (c)(3)(ii) applies if a hybrid entity or transparent entity to which paragraph (c)(3)(i) of this section applies owns, directly or indirectly (other than through a hybrid entity or transparent entity), an interest in an entity that is treated as a disregarded entity, partnership, or grantor trust for U.S. tax purposes, but is not a hybrid entity or a transparent entity. For example, the rules of this paragraph would apply when a hybrid entity holds an interest in a limited partnership created in the United States and, for both U.S. and foreign tax purposes the entity is considered a partnership. In such a case, and except to the extent provided in paragraph (c)(4) of this section, items of income, gain, deduction, and loss that are reflected on the books and records of such disregarded entity, partnership or grantor trust, as determined under paragraph (c)(3)(i) of this section, shall be treated as being reflected on the books and records of the hybrid entity or transparent entity for purposes of applying paragraph (c)(3)(i) of this section. See § 1.1503(d)–7(c) *Example 26*.

(4) *Special rules.* The following special rules shall apply for purposes of attributing items to separate units or interests in transparent entities under this section:

(i) *Allocation of items between certain tiered separate units and interests in transparent entities*—(A) *Foreign branch separate unit.* This paragraph (c)(4)(i) applies where a hybrid entity or transparent entity owns directly or indirectly (other than through a hybrid entity or a transparent entity), a foreign branch separate unit. For purposes of determining items of income, gain, deduction, and loss of the domestic owner that are attributable to the domestic owner's foreign branch separate unit described in the preceding sentence, only items of income, gain, deduction, and loss that are attributable to the domestic owner's interest in the hybrid entity, or transparent entity, as provided in paragraph (c)(3) of this section, shall be taken into account. Further, only assets, liabilities, and activities of the domestic owner's interest in the hybrid entity or the transparent entity under paragraph (c)(2) of this section

when applying the principles of 864(c)(2), (c)(4), (c)(5) (as set forth in § 1.864-4(c), and §§ 1.864-5 through 1.864-7), and § 1.882-5 (as modified in paragraph (c)(2)(ii) of this section). See § 1.1503(d)-7(c) *Examples 25 and 26*.

(B) *Hybrid entity separate unit or interest in a transparent entity*. For purposes of determining items of income, gain, deduction, and loss that are attributable to a hybrid entity separate unit or an interest in a transparent entity described in paragraph (c)(3) of this section, such items shall not be taken into account to the extent they are attributable to a foreign branch separate unit pursuant to paragraph (c)(4)(i)(A) of this section. See § 1.1503(d)-7(c) *Examples 25 and 26*.

(ii) *Combined separate unit*. If two or more individual separate units defined in § 1.1503(d)-1(b)(4)(i) are treated as one combined separate unit pursuant to § 1.1503(d)-1(b)(4)(ii), the items of income, gain, deduction, and loss that are attributable to the combined separate unit shall be determined as follows:

(A) Items of income, gain, deduction, and loss are first attributed to each individual separate unit without regard to § 1.1503(d)-1(b)(4)(ii), pursuant to the rules of paragraphs (c) through (e) of this section.

(B) The combined separate unit then takes into account all of the items of income, gain, deduction, and loss attributable to its individual separate units pursuant to paragraph (c)(4)(ii)(A) of this section. See § 1.1503(d)-7(c) *Examples 25 and 26*.

(iii) *Gain or loss on the direct or indirect disposition of a separate unit or an interest in a transparent entity—(A) In general*. This paragraph (c)(4)(iii) applies for purposes of attributing items of income, gain, deduction, and loss that are recognized on the sale, exchange, or other disposition of a separate unit or an interest in a transparent entity (or an interest in a disregarded entity, partnership, or grantor trust that owns, directly or indirectly, a separate unit or an interest in a transparent entity). For purposes of this paragraph (c)(4)(iii), items taken into account on the sale, exchange, or other disposition include loss recapture income or gain under section

367(a)(3)(C) or 904(f)(3), and gain or loss recognized by the domestic owner as the result of an election under section 338. In cases where this paragraph (c)(4)(iii)(A) applies, items taken into account on the sale, exchange, or other disposition shall be attributable to the separate unit or the interest in the transparent entity to the extent of gain or loss that would have been recognized had the separate unit or transparent entity sold all its assets (as determined in paragraph (f) of this section) in a taxable exchange, immediately before the sale, exchange, or other disposition (deemed sale). For purposes of a deemed sale described in this paragraph (c)(4)(iii), the assets are treated as being sold for an amount equal to their fair market value, plus the assumption of the liabilities of the separate unit or interest in a transparent entity (as determined in paragraph (f) of this section). See § 1.1503(d)-7(c) *Example 27*.

(B) *Multiple separate units or interests in transparent entities*. This paragraph (c)(4)(iii)(B) applies to a sale, exchange, or other disposition described in paragraph (c)(4)(iii)(A) of this section that results in more than one separate unit or interest in a transparent entity being, directly or indirectly, disposed of. In such a case, items of income, gain, deduction, and loss recognized on such sale, exchange, or other disposition are allocated and attributed to each separate unit or interest in a transparent entity, based on the relative gain or loss that would have been recognized by each separate unit or interest in a transparent entity pursuant to a deemed sale of their assets. See § 1.1503(d)-7(c) *Example 28*.

(iv) *Inclusions on stock*. Any amount included in income of a domestic owner arising from ownership of stock in a foreign corporation (for example, under sections 78, 951, or 986(c)) through a separate unit, or interest in a transparent entity, shall be attributable to the separate unit or interest in a transparent entity, if an actual dividend from such foreign corporation would have been so attributed. See § 1.1503(d)-7(c) *Example 24*.

(v) *Foreign currency gain or loss recognized under section 987*. Foreign currency gain or loss of a domestic owner

recognized under section 987 as a result of a transfer or remittance shall not be attributable to a separate unit or an interest in a transparent entity.

(vi) *Recapture of dual consolidated loss.* If all or a portion of a dual consolidated loss that was attributable to a separate unit is included in the gross income of a domestic owner under the recapture provisions of §1.1503(d)–6(h), such amount shall be attributable to the separate unit that incurred the dual consolidated loss being recaptured. See §1.1503(d)–7(c) *Examples 38 and 40*.

(d) *Foreign tax treatment disregarded.* The fact that a particular item taken into account in computing the income or dual consolidated loss of a dual resident corporation or a separate unit, or the income or loss of an interest in a transparent entity, is not taken into account in computing income (or loss) subject to a foreign country's income tax shall not cause such item to be excluded from being taken into account under paragraph (b), (c), or (e) of this section.

(e) *Items generated or incurred while a dual resident corporation, a separate unit, or a transparent entity.* For purposes of determining the amount of the dual consolidated loss of a dual resident corporation for the taxable year, only the items of income, gain, deduction, and loss generated or incurred during the period the dual resident corporation qualified as such shall be taken into account. For purposes of determining the amount of income of a dual resident corporation for the taxable year, all the items of income, gain, deduction, and loss generated or incurred during the year shall be taken into account. For purposes of determining the amount of the income or dual consolidated loss attributable to a separate unit, or the income or loss attributable to an interest in a transparent entity, for the taxable year, only the items of income, gain, deduction, and loss generated or incurred during the period the separate unit or the interest in the transparent entity qualified as such shall be taken into account. For purposes of this paragraph (e), the allocation of items to periods shall be made under the principles of §1.1502–76(b).

(f) *Assets and liabilities of a separate unit or an interest in a transparent entity.* A separate unit or an interest in a transparent entity shall be treated as owning assets to the extent items of income, gain, deduction, and loss from such assets would be attributable to the separate unit or interest in the transparent entity under paragraphs (c) through (e) of this section. Similarly, liabilities shall be treated as liabilities of a separate unit, or an interest in a transparent entity, to the extent interest expense incurred on such liabilities would be attributable to the separate unit, or the interest in a transparent entity, under paragraphs (c) through (e) of this section.

(g) *Basis adjustments*—(1) *Affiliated dual resident corporation or affiliated domestic owner.* If a member of a consolidated group owns stock in an affiliated dual resident corporation or an affiliated domestic owner that is a member of the same consolidated group, the member shall adjust the basis of the stock in accordance with the provisions of §1.1502–32. Corresponding adjustments shall be made to the stock of other members in accordance with the provisions of §1.1502–32. In the case where two or more individual separate units are treated as a combined separate unit pursuant to §1.1503(d)–1(b)(4)(ii), see paragraph (g)(3) of this section.

(2) *Interests in hybrid entities that are partnerships or interests in partnerships through which a separate unit is owned indirectly*—(i) *Scope.* This paragraph (g)(2) applies for purposes of determining the adjusted basis of an interest in—

(A) A hybrid entity that is a partnership; and

(B) A partnership through which a domestic owner indirectly owns a separate unit.

(ii) *Determination of basis of partner's interest.* The adjusted basis of an interest described in paragraph (g)(2)(i) of this section shall be adjusted in accordance with section 705 and this paragraph (g)(2). The adjusted basis shall not be decreased for any amount of a dual consolidated loss that is attributable to the partnership interest, or separate unit owned indirectly through the partnership interest, as applicable,

that is not absorbed as a result of the application of § 1.1503(d)-4(b) and (c). The adjusted basis shall, however, be decreased for the amount of such dual consolidated loss that is absorbed in a carryover or carryback taxable year. The adjusted basis shall be increased for any amount included in income pursuant to § 1.1503(d)-6(h) as a result of the recapture of a dual consolidated loss that was attributable to the interest in the hybrid partnership, or separate unit owned indirectly through the partnership interest, as applicable.

(3) *Combined separate units.* This paragraph (g)(3) applies where two or more individual separate units of one or more affiliated domestic owners are treated as one combined separate unit pursuant to § 1.1503(d)-1(b)(4)(ii). In such a case, a member owning stock in an affiliated domestic owner of the combined separate unit shall adjust the basis in the stock of such domestic owner as provided in paragraph (g)(1) of this section, and an affiliated domestic owner shall adjust its basis in a partnership, as provided in paragraph (g)(2) of this section, taking into account only those items of income, gain, deduction, or loss attributable to each individual separate unit, prior to combination. For purposes of this rule, if the dual consolidated loss attributable to a combined separate unit is subject to the domestic use limitation of § 1.1503(d)-4(b), then for purposes of this paragraph (g) and § 1.1502-32, the dual consolidated loss shall be allocated to an individual separate unit to the extent such individual separate unit contributed items of deduction or loss giving rise to the dual consolidated loss. In addition, if one or more affiliated domestic owners are required to recapture all or a portion of a dual consolidated loss pursuant to paragraph (h) of this section, such recapture amount shall be allocated to the affiliated domestic owner of the individual separate units composing the combined separate unit, to the extent such individual separate units contributed items of deduction or loss giving rise to the recaptured dual consolidated loss.

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#### § 1.1503(d)-6 Exceptions to the domestic use limitation rule.

(a) *In general*—(1) *Scope and purpose.* This section provides certain exceptions to the domestic use limitation rule of § 1.1503(d)-4(b). Paragraph (b) of this section provides an exception for bilateral elective agreements. Paragraph (c) of this section provides rules regarding an exception that applies when there is no possibility of a foreign use. Paragraphs (d) through (h) of this section provide rules for an exception where a domestic use election is made. Paragraph (e) of this section provides rules with respect to triggering events, and paragraph (f) of this section provides rules regarding exceptions to triggering events. Paragraph (g) of this section provides rules with respect to the annual certification reporting requirement. Paragraph (h) of this section provides rules regarding the recapture of dual consolidated losses. Finally, paragraph (j) of this section provides rules regarding the termination of domestic use agreements and the annual certification requirement.

(2) *Absence of foreign affiliate or foreign consolidation regime.* The absence of a foreign affiliate or a foreign consolidation regime alone does not constitute an exception to the domestic use limitation rule. This is the case because it is still possible that all or a portion of the dual consolidated loss may be put to a foreign use. For example, there may be a foreign use with respect to an affiliate acquired in a year subsequent to the year in which the dual consolidated loss was incurred. In addition, a foreign use may occur in the absence of a foreign consolidation regime through a sale, merger, or similar transaction. See § 1.1503(d)-7(c) *Example 2*.

(3) *Foreign insurance companies treated as domestic corporations.* The exceptions contained in this section shall not apply to losses of a foreign insurance company that is a dual resident corporation under § 1.1503(d)-1(b)(2)(ii), or to losses attributable to any separate unit of such foreign insurance company. In addition, these exceptions shall not apply to losses described in the preceding sentence that, subject to the rules of § 1.1503(d)-4(d), carry over to a domestic corporation pursuant to